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SIPDIS

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TAGS: ECON EFIN TU
SUBJECT: FIRST WAVES OF FINANCIAL CRISIS REACH TURKEY

REF: A. ANKARA 1763
¶B. ANKARA 1744

Classified By: Economic Counselor Dale Eppler for reasons 1.4 b and d.

¶1. (C) Summary: The financial crisis is affecting Turkey by reducing its GDP growth, employment, and exports, and by reducing capital and credit flows into Turkey. Combined, these have the potential to undermine Turkey,s relatively well-capitalized and lightly-leveraged banks (reftels). Economic indicators are turning negative, with the dollar exchange rate at a two-year high and interest rates exceeding 21%. Foreign banks have experienced a mini-run on deposits, and there are doubts whether some Turkish banks and companies will be able to rollover large foreign currency credit lines coming due in the next few months. Two recent privatization deals have hit financial snags due to banks pulling their promised financing. The GOT has responded to the crisis with public displays of optimism and a few policy initiatives. The Central Bank was widely praised for opening an FX Depot market to improve inter-bank liquidity, and the Finance Ministry has announced an incentive plan to convince Turks to repatriate some of their $100 billion in funds held offshore. But the GOT approach thus far has been reactive, not proactive, and the business community wants the GOT to negotiate quickly a full standby agreement with the IMF and increase deposit insurance to get ahead of the crisis. The GOT seems to assume that the Turkish banking sector is immune to the crisis due to the 2001 banking reforms, but banks face both increasing credit risk (as the slowing economy hurts borrowers) and FX risks (from borrowing abroad and lending at home). Financial problems in any of the seven largest banks (holding 79% of banking assets) likely would cause systemic problems. End summary.

How the Crisis is Reaching Turkey

¶2. (C) Despite recent public assertions by the Prime Minister that Turkey would not be significantly affected by the global financial crisis, there are many indications that Turkey already is feeling its effects. There are two major paths for the crisis to reach Turkey. The first is via the expected drop in Turkey,s GDP growth due to global recession and, in particular, a sharp recession in Europe (the EU is Turkey,s main trading partner). The second way is through finance. Europe is the source of much of Turkey,s investment capital, and the chaos in Europe,s financial sector will reduce capital and credit flows to Turkey. Turkey needs to import billions to finance its large current account deficit (CAD), and the Turkish private sector has built up an estimated USD 100 billion in foreign currency-denominated debt (taking advantage of low interest rates offshore and the strong lira) that they will have difficulty rolling over. Repaying this debt will not only

expose them to currency risk but also force them to reduce business activity and employment in the absence of financing. These two channels combined have the potential to open undermine the financial strength of Turkey,s relatively well-capitalized and not highly leveraged banks (reftels).

Economic Indicators Turning Negative

¶3. (SBU) The 2009 budget being presented to the parliament on October 17 reportedly has 2009 GDP growth estimated at 4% and inflation at 7.5%. Private estimates already are lower, some projecting only 2.5% growth, with higher inflation.

¶4. (SBU) The dollar hit a two-year peak of 1.52 YTL ($.66) the morning of October 17. The lira has fallen approximately 20% against the dollar since the end of August. Until now, the high lira exchange rate has been one of the best Turkish defenses against inflation (because Turkey imports a large amount of intermediate goods and industrial inputs) and private analysts are increasing their inflation projections. Reflecting inflation concerns, the benchmark bond rate jumped to 21.37% on October 16, up from 20.35% just one day earlier.

¶5. (SBU) The most recent data shows unemployment increased from 8.8% to 9.4% in June-August. Agribusiness and government officials in Adana (with 17% unemployment) told us recently that they expect unemployment to increase as European trade and investment slow. The textile sector, with its large labor force, is expected to be particularly hard hit.

¶6. (SBU) The current account deficit for August matched the consensus estimate of $3.3 billion, and was lower than July's $4.1 billion. However, it was still almost double the CAD in August 2007. The one-year moving average CAD was $49 billion, around 6.5% of GDP, and we expect the year-end CAD to reach 7% of GDP. On the financing side, net foreign direct investment covered only 25% of the August CAD, down from two-thirds coverage one year earlier.

Financing is Becoming More difficult

¶6. (SBU) A senior foreign banker in Istanbul told us that local depositors withdrew USD 100 million from his bank earlier this month, and that other foreign-owned banks were experiencing similarly high withdrawal rates. He attributes this to Turks reading about foreign banks experiencing financial problems and pulling their money out of fear. He added that three large Turkish banks, Garanti, Vakif, and Akbank, are vulnerable in the short term because they have USD $3 billion in foreign currency-denominated debt coming due and it was a "big question" whether they would be able to roll it over. He thought these banks could get by without rollovers for about six months, but would then experience financing problems. He noted the GOT also has significant short-term, foreign currency-denominated debt coming due, and he thinks it will be "complicated" for the GOT to roll all of this debt over.

¶7. (C) Kazim Turker, Chairman and CEO of Turkerler Group (a construction and energy company with 2007 revenues of USD 350 million) told the Ambassador October 17 he is worried about the longer term effects to the Turkish economy from the global financial crisis. Turker said his company will weather the storm because they do not have any short term debts. He also said he has been able to find creative solutions to financing problems, such as Turkerler,s purchase of the Derince port on the Marmara Sea. Turkey,s Akbank had initially agreed to loan USD 400 million for the project but recently told Turker they could not make good on the deal and asked for a delay. Turker said he then decided to sell half of the equity in the project to Swiss company MSC which brought the necessary financing to finalize the deal.

¶8. (C) Turker expressed concerns about Turkish banks having difficulty rolling over FX debt that will come due in January and February. Turker also predicted the GOT may face difficulties renewing its debt and recommended the GOT come to an agreement with the IMF right away as insurance against a major financial crisis in Turkey. "They will have to do it, sooner or later." The GOT is not paying sufficient attention to the financial crisis and the PM is getting bad advice, according to Turker.

¶9. (SBU) Global Investments, which won the tender for the privatization of the Ankara city gas distribution network, announced October 17 that it would not be able to fulfill its $1.115 billion bid because banks had withdrawn their financing for the project. According to documents on Global,s website, the five banks involved in the financing package are Bayerische Hypo-und Vereinsbank AG, ABN Amro Bank N.V., T. Garanti Bank, Akbank, and Yapi Kredit Bankasi. According to Turker, the Izmir port privatization may face a similar collapse due to lack of financing.

¶10. (U) Tim Ash, Head of CEEMEA research of the Royal Bank of Scotland, wrote on October 16 that Turkey has particularly onerous public and external debt financing needs. He estimates 2009 roll-over volumes of USD $145 billion in external financing and USD $100 billion in public sector debt.

¶11. (C) Leading business association TUSIAD told us they continue to push for the GOT to focus on the economy and work on reforms. Privately, they would like to see SDIF insurance on deposits increased from the current 50,000 YTL ($35,000) limit to bolster depositor confidence and keep funds in Turkey. They do not plan to make this call public, to avoid triggering a run on the banks. TUSIAD also wants the GOT to increase its EU accession efforts, and thinks it is past time for the GOT to commit to an arrangement with the IMF.

GOT Slowly Responding to Crisis
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¶12. (SBU) While continuing to maintain an optimistic outlook in public comments (including comments by the Prime Minister that the crisis could even turn out to be an opportunity for Turkey), the GOT has begun to take some steps in reaction to the crisis. As reported reftel A, the Central Bank opened a Foreign Exchange Depot Market to help with liquidity in the interbank market, a widely praised move.

¶13. (SBU) On October 15, Finance Minister Unakitan announced new GOT initiatives to respond to the crisis. The most substantive was a new law to give tax incentives for Turkish citizens to repatriate their offshore funds (estimated to be around USD $100 billion, mainly held in Europe) over a three-month period. The GOT,s stated goal is to decrease Turkey,s Current Account deficit with the inflow of funds. According to press reports, the GOT proposal would include a clause stating that "no inspections will be carried out regarding the money brought to Turkey within the framework of this regulation." (Comment: while the GOT,s focus seems to be to provide a tax amnesty for repatriating funds in time of need, this would seem to open the Turkish banking system to widescale money laundering concerns. End comment.) Unakitan also said the 10% withholding tax on domestic investments would be suspended and that the GOT would set up a special lending facility for small and medium enterprises.

¶14. (SBU) Unakitan also tried to assure investors. He mentioned the 2009 budget will have a deficit below 1.5%, which will not curtail public investment (as noted . He reiterated the GOT,s commitment to fiscal discipline and said it intends to press ahead with a new fiscal rule. Unakitan said there was no need for Turkey to increase its deposit insurance from the current YTL 50,0000 due to Turkey,s 2001 banking reforms. He also warned banks against calling in business loans early in an attempt to raise cash.

(Comment: While we have nothing to substantiate rumors that banks are calling loans, his warning implies the problem is real. End comment.) The Ministry of Finance later released a statement that all discretionary GOT expenditures were suspended until year-end and urged energy conservation by public institutions.

¶15. (C) Comment: The Turkish banking sector remains solid, well-capitalized and lightly leveraged by world standards. Non-performing loans in September were only 3.02% (less than a year ago), and the foreign borrowing to deposit ratio for the system stood at just 18.02%. But this does not mean that the sector is immune to the financial crisis, as the government seems to assume. Even the best run bank can be undermined when its once-solid borrowers have problems repaying loans, and Turkish banks also face foreign currency risks in borrowing abroad and lending at home. The Turkish banking sector is highly concentrated -- 79% of Turkish banking assets are held by seven banks: Ziraat (state-owned); Akbank (49% owned by Citigroup); Halkbank (state-owned, scheduled to be privatized); Isbank; Garanti Bank (49% owned by GE investments); Vakifbank (state-owned); and Yapi Kredi Bank (owned by Unicredito of Italy). Financial problems in one of these banks would likely create systemic problems. The foreign banking sector also faces the possibility that a failure of one foreign bank could undermine Turkish confidence in foreign-owned banks in general. 25 of the 50 banks operating in Turkey are 100% foreign-owned. End comment.

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